TD Bank Financial Group

TD Economics

The Weekly Bottom Line

February 22, 2008

HIGHLIGHTS

- **U.S. consumer prices soar, while Fed sharply reduces U.S. economic growth forecast**
- **Canadian inflation slows; rate cuts on horizon**

A full plate of data was served on both sides of the border this week, bisected by the minutes from the January 29-30 FOMC meeting and with a garnish of speeches from central bank officials throughout. The serving of limp economic data proved to be a sure recipe for volatility in financial markets.

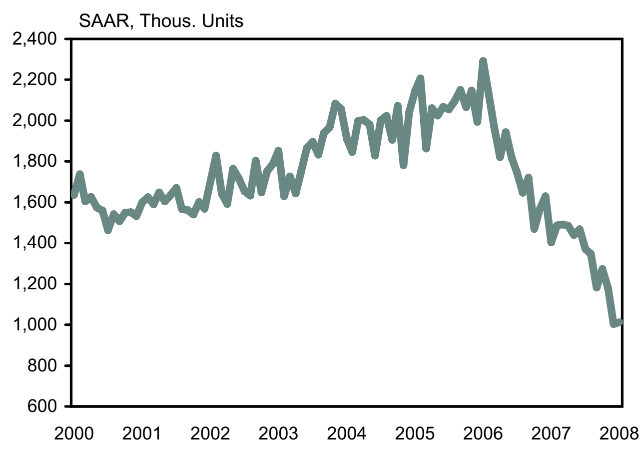
With this week's data releases, market concern about stagflation has again returned to the forefront in the U.S., as policy makers come to grips with the combination of rising inflation in the face of a staggering economy. In January, inflation in the U.S. rose to 4.3% y/y – matching the fastest clip since the aftermath of Hurricane Katrina. At the same time, economic growth in the U.S. appears to be deteriorating, with a weaker-than-expected manufacturing report from the Philadelphia Federal Reserve Bank and a drop (-0.1%) in the Conference Board's gauge of leading U.S. economic indicators.

Meanwhile, Canada has none of the inflation concerns plaguing the U.S. Indeed, the core inflation rate continued its descent in January, falling to 1.4% y/y. However, Canada will certainly get a big dose of the "stag" part if the U.S. economy continues to worsen, since the country's economy is closely tied to the U.S.

Reflecting this economic situation, North American stock markets retreated yesterday afternoon on renewed worries over the U.S. economy, eroding momentum observed early in the week. The Dow Jones industrials closed Thursday down 143 points from the previous day, while in Canada, the S&P/TSX composite index fell 42 points.

Recent TD Economics Research
February 22, 2008 - Canadian Retail Sales
February 21, 2008 - What's Going On With U.S. Inflation?
February 20, 2008 - The 2008 British Columbia Budget
February 20, 2008 - U.S. Consumer Price Index
February 19, 2008 - TD Alternate Inflation Monitor
February 19, 2008 - Canadian Consumer Price Index

U.S. HOUSING STARTS



Source: Census Bureau/Haver Analytics

US economy weakens

This week brought data that sparked worries of further weakness in the U.S. economy. Housing starts in the U.S. rose a less-than-expected 0.8% in January. Following the wettest December in five years, some bounce-back in starts was expected, but the tiny gain last month serves to further drive home the sickly nature of the market. Also, despite the jump in the headline number for starts, single unit starts fell by 41,000K, bringing it to its lowest level since 1991. Home price deflation also continues unabated. Looking ahead, don't count on starts to stabilize soon. New home sales are still falling faster than housing starts, while inventories of unsold new and existing homes remain sky-high, limiting the need for new supply. Clearly, the housing market has yet to hit bottom.

The fear of a deepening U.S. economic slowdown was also compounded with the dramatic drop in the Philadelphia Fed index. The Philly Fed drop to -24.0 in February extended the surprising freefall to -20.9 in January. This confirms that January's giant 19.3 point plunge was not just a fluke, and that manufacturing conditions really are that weak in the Philadelphia region. Combined with the NY Empire Fed index's big drop in February, we're now expecting to see the ISM manufacturing index drop to well below 50 in February.

Meanwhile, the Fed also stoked market anxieties over U.S. prospects, with a prediction of sluggish growth (1.3 to 2 % compared with an earlier estimate of 1.8 to 2.5 %) and rising unemployment in 2008 (5.2 to 5.3% compared with 4.8 to 4.9%), in the January FOMC minutes.

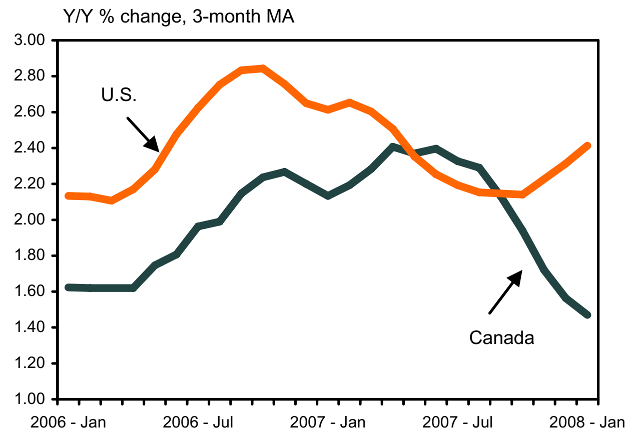
Rising inflation puts Fed on the hot seat

Even as the U.S. economy falters, inflation has become the pesky problem that just won't go away. Prices in January shot up 4.3% from year-ago levels, compared to 4.1% in December. Total inflation is being whipped up by rising commodity prices for such things as oil, which breached the $100/bbl mark this week amid global supply jitters (and remains above $98/bbl), and record food prices, all exacerbated by the weak greenback that is hiking the cost of imports. Even more troubling is the fact that core inflation is also creeping up and at 2.5% is now at a 10 month high. To make matters worse, the three-month annualized trend has accelerated to 3.1%, the highest level in over a year. Also, as outlined in the FOMC minutes, the Fed is bracing for higher core PCE inflation this year (2 to 2.2% compared with an earlier estimate of 1.7 to 1.9 %).

Persistent inflation hampers the Fed in its scope to cut interest rates to shore-up faltering U.S. economic growth. The quandary for the Fed over how to respond to weakening growth and rising inflation was underlined by St Louis Fed President Poole, who said that too deep cuts in interest rates to avert recession could risk driving inflation to an "unacceptable" level (for details please refer to the TD Economics paper 'What's Going On With U.S. Inflation?').

With the next FOMC meeting some distance away on March 18, every piece of economic evidence between now and then will be closely scrutinized. It is our belief that the Fed will cut by another 50 bps at its next meeting, leaving the fed funds rate at 2.5%. Beyond that, however, nagging inflation will likely cap the Fed's willingness to ease policy further, as the risk of over-stimulus begins to outweigh the benefits. Besides, the Fed is likely to start seeing evidence of a recovery in growth over the second half of 2008, as the accommodative monetary policy and fiscal stimulus plan begin to have a positive impact on growth.

CORE CPI IN U.S. AND CANADA



Source: Statistica Canada/Haver Analytics

Canadian inflation: not quite the same issue

Unlike in the U.S., the Canadian annual CPI rate actually cooled in January to 2.2% from 2.4% in the prior month, as the GST cut at the start of the year chopped an estimated 0.5 percentage points from the overall index. Core CPI, the Bank's preferred inflation measure and which ignores the impact of indirect tax changes, also fell further from 1.5% y/y in December to 1.4% y/y in January –its lowest since July 2005. Clearly, the mighty loonie is weighing heavily on inflation, keeping it well below U.S. levels. Going forward, the elevated loonie will continue to spur Canadian retailers to remain competitive. This, along with favourable year-ago comparisons in the next few months is why both we and the Bank of Canada expect to see inflation soften further by mid-2008.

Canada's strong position on inflation gives the Bank of Canada ample room to cut interest rates in order to give some lift to the Canadian economy, which appears to be headed for slower growth. Indeed, in spite of continued support from robust domestic demand (as demonstrated by a 5.5% annual rise in retail sales in Q4), the economy is likely to expand by a miserly 1% (annualized) or worse in Q4, as declines in exports and manufacturing shipments weigh in on growth. As a result, we are predicting that the Bank will cut rates by an additional 75bps over the next two meetings. Dovish comments from the Bank of Canada Governor Carney at a speaking engagement in British Columbia on Monday delivered much the same message that further monetary stimulus would be needed as a means of offsetting flagging external demand.

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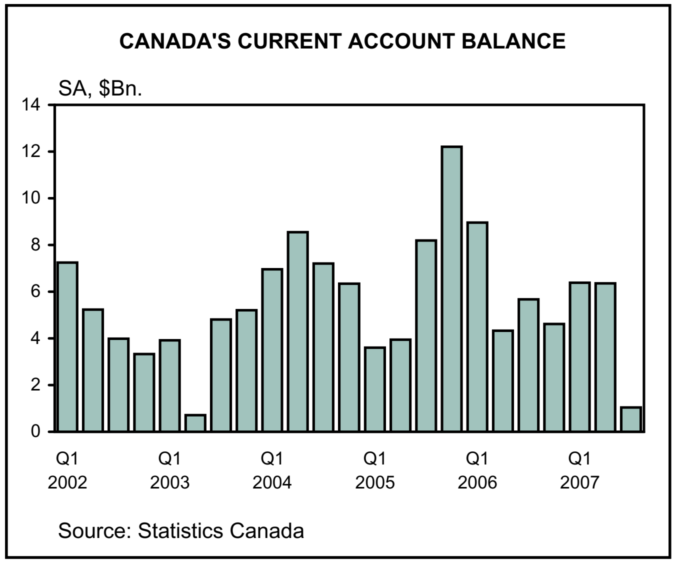
UPCOMING KEY ECONOMIC RELEASES

Canadian Current Account Balance – Q4

Release Date: February 29/08
Q3 Result: $11.1B (non-annualized)
TD Forecast: -$0.9B
Consensus: -$0.2B

It's time for Canada to say good-bye to its days of twin surpluses, as the Canadian current account is likely to fall into deficit territory in Q4 2007 for the first time since 1999. We're forecasting a current account deficit of $0.9B, non-annualized, with the deterioration in the CA balance coming from a substantial softening in the goods and services balance over the last couple of quarters. From the previously-released international merchandise trade data, we know that the goods balance fell to only $9.2B for the quarter, from $10.5B in Q3. The services balance is also likely to deteriorate further, since the strength of the Canadian dollar during the quarter likley led to an increase in Canadians vacationing in the U.S., adding to the travel deficit. We think that the cumulative appreciation of the Canadian dollar over the last few years may have finally caught up the Canadian exporters, with the weakness in exports likely to persist through 2008, leading to the first annual current account deficit since 1998.



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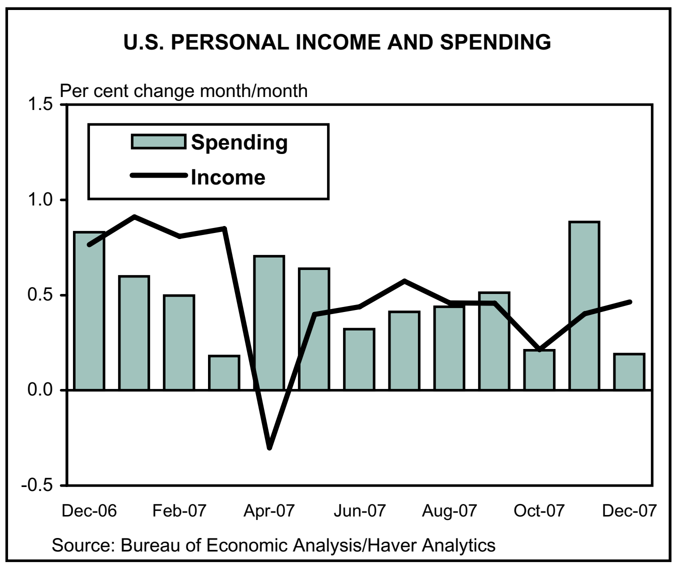
U.S. Personal Income and Spending - January

Release Date: February 29/08
December Result: income +0.5%; spending +0.2%;
core PCE deflator +0.2% M/M, 2.2% Y/Y
TD Forecast: income +0.2%; spending +0.3%;
core PCE deflator +0.3% M/M, 2.2% Y/Y
Consensus: income +0.2%; spending +0.2%;
core PCE deflator +0.2% M/M, 2.2% Y/Y

We're expecting to see U.S. income and spending continue to falter in January, with income taking an especially big hit. Since hours worked fell by 2.3% in January and the economy shed 17,000 jobs, the pace of growth in the wages and salary component will likely weaken substantially, leading income growth to soften to only 0.2% M/M. Meanwhile, we expect spending to come in at 0.3%, matching the gain in January retail sales. However, real personal consumption will likely be much weaker. And with the strength that we saw in core CPI in January, we're expecting to see the core PCE deflator increase by 0.3% on a monthly basis, with the Y/Y measure unchanged at 2.2%.



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RECENT KEY ECONOMIC INDICATORS
February 18-22, 2008

Date	Economic Indicators	Data for	Units	Current	Prior	
Canada						
Feb. 19	Consumer Price Index (CPI)	Jan.	Y/Y % chg.	2.2	2.4	
Feb. 19	CPI - excl. 8 most volatile items	Jan.	Y/Y % chg.	1.4	1.5	
Feb. 20	Internatinoal Securities Transactions	Dec.	$C, blns	1.5	4.9	R▼
Feb. 20	Leading Indicators	Jan.	% change	0.0	0.0	R▲
Feb. 22	Retail Sales	Dec.	% change	0.8	0.9	R▲
Feb. 22	Retail Sales - excl. autos	Dec.	% change	0.4	2.0	R▲
United States						
Feb. 20	Consumer Price Index (CPI)	Jan.	% change	0.3	0.4	R▲
Feb. 20	CPI - excl. food and energy	Jan.	% change	0.2	0.2	
Feb. 20	CPI Core Index	Jan.	Index	--	213.1	
Feb. 20	Housing Starts	Jan.	Thousands	1,010	1,004	R▼
Feb. 20	Building Permits	Jan.	Thousands	1,050	1,080	R▲
Feb. 21	Weekly Initial Jobless Claims	16-Feb	Thousands	349	358	R▲
Feb. 21	Leading Indicators	Jan.	% change	-0.1	-0.1	R▲

Source: Bloomberg, TD Economics

UPCOMING NORTH AMERICAN ECONOMIC CALENDAR
February 25-29, 2008

Release Date	Economic Indicators	Data for Period	Units	Consensus Forecast	Prior
Canada					
Feb. 29	Current Account (BOP)	Q4-07	$C, blns	-0.2	1.0
Feb. 29	Industrial Product Price Index	Jan.	% change	0.8	1.1
Feb. 29	Raw Materials Price Index	Jan.	% change	0.5	0.2
United States					
Feb. 25	*Fed Governor Koszner speaks on risk management in New York*				
Feb. 25	Existing Home Sales	Jan.	Millions	4.8	4.9
Feb. 25	*Fed governor Mishkin speaks on stabilizing inflation in North Carolina*				
Feb. 26	Producer Price Index (PPI)	Jan.	% change	0.3	-0.1
Feb. 26	PPI excl. food and energy	Jan.	% change	0.2	0.2
Feb. 26	S&P/CS Composite-20	Dec.	Index	--	188.8
Feb. 26	Consumer Confidence	Feb.	Index	83.0	87.9
Feb. 26	Richmond Fed Index	Feb.	Index	-5.0	-8.0
Feb. 26	*Fed Vice Chairman Kohn speaks on the economy and monetary policy in Wilmington, NC*				
Feb. 27	Durable Goods Orders	Jan.	% change	-4.0	5.2
Feb. 27	*Fed Chairman Bernanke releases report on the Economy and Fed Policy*				
Feb. 27	*Fed Governor Mishkin speaks on financial literacyat the National Press Club in Washington, DC*				
Feb. 27	New Home Sales	Jan.	Thousands	600.0	604.0
Feb. 28	Personal Consumption (prelim)	Q4-07	Ann. % chg.	2.0	2.0
Feb. 28	Weekly Initial Jobless Claims	23-Feb	Thousands	350.0	349.0
Feb. 28	*Fed Chairman Bernake testifies before Senate Banking Committee*				
Feb. 29	Personal Income	Jan.	% chg.	0.2	0.5
Feb. 29	Personal Spending	Jan.	% chg.	0.2	0.2
Feb. 29	PCE Deflator	Jan.	Y/Y % chg.	3.5	3.5
Feb. 29	PCE Core	Jan.	Y/Y % chg.	2.2	2.2
Feb. 29	Chicago Purchasing Managers Index	Feb.	Index	50.0	51.5
Feb. 29	*Fed Governor Mishkin and Boston Fed President Rosengren speak at monetary policy conference in New York*				
Feb. 29	*Atlanta Fed President Lockhart speaks on a panel discussion on subprime mortgages in Atlanta, GA*				
Feb. 29	*Chicago Fed President Evans and St. Louis Fed President Poole speak at monetary policy conf. in New York*				

Source: Bloomberg, TD Economics

G-7 ECONOMIC RELEASES AND EVENTS

Date	Time*	Country	Economic Indicator/Event	Data for Period	Units	Consensus Forecast	Last Period
Feb. 25	9:50	*U.S.*	*Fed Governor Koszner speaks on risk management in New York*				
	10:00	U.S.	Existing Home Sales	Jan.	Millions	4.8	4.9
	15:30	*U.S.*	*Fed governor Mishkin speaks on stabilizing inflation in North Carolina*				
	18:50	Japan	Corporate Service Price Index	Jan.	Y/Y % chg.	1.4	1.4
Feb. 26	4:00	Germany	IFO Business Climate Survey	Feb.	Index	103.0	103.4
	4:00	Germany	IFO Survey - Current Assessment	Feb.	Index	107.3	107.9
	4:00	Germany	IFO Survey - Business Expectations	Feb.	Index	98.8	99.0
	4:30	U.K.	Total Business Investment (prelim.)	Q4-07	Y/Y % chg.	2.9	6.6
	8:30	U.S.	Producer Price Index (PPI)	Jan.	% change	0.3	-0.1
	8:30	U.S.	PPI excl. food and energy	Jan.	% change	0.2	0.2
	9:00	U.S.	S&P/CS Composite-20	Dec.	Index	--	188.8
	10:00	U.S.	Consumer Confidence	Feb.	Index	83.0	87.9
	10:00	U.S.	Richmond Fed Index	Feb.	Index	-5.0	-8.0
	12:15	*U.S.*	*Fed Vice Chairman Kohn speaks on the economy and monetary policy in Wilmington, NC*				
Feb. 27	4:00	EU	M3 Money Supply Growth	Jan.	Y/Y % chg.	11.3	11.5
	5:00	UK	Gross Domestic Product (advance)	Q4-07	Q/Q % chg.	0.6	0.6
	8:30	U.S.	Durable Goods Orders	Jan.	% change	-4.0	5.2
	10:00	*U.S.*	*Fed Chairman Bernanke releases report on the Economy and Fed Policy*				
	10:00	*U.S.*	*Fed Governor Mishkin speaks on financial literacyat the National Press Club in Washington, DC*				
	10:00	U.S.	New Home Sales	Jan.	Thousands	600.0	604.0
	19:50	Japan	Industrial Production (prelim.)	Jan.	% change	-0.8	1.4
	19:50	Japan	Retail Sales	Jan.	% change	1.8	-0.8
Feb. 28	2:45	France	Consumer Confidence Indicator	Feb.	Index	-34.0	-34.0
	3:55	Germany	Unemployment Change	Feb.	Thousands	-50.0	-89.0
	3:55	Germany	Unemployment Rate	Feb.	Per cent	8.0	8.1
	4:00	EU-12	Purchasing Managers Index (Retail)	Feb.	Index	--	48.1
	4:00	Germany	Purchasing Managers Index (Retail)	Feb.	Index	--	44.2
	4:00	France	Purchasing Managers Index (Retail)	Feb.	Index	55.0	56.2
	8:30	U.S.	Personal Consumption (prelim)	Q4-07	Ann. % chg.	2.0	2.0
	8:30	U.S.	Weekly Initial Jobless Claims	23-Feb	Thousands	350.0	349.0
	10:00	*U.S.*	*Fed Chairman Bernake testifies before Senate Banking Committee*				
	16:45	NZ	Trade Balance	Jan.	NZ, blns	--	0.3
	19:30	Japan	Jobless Rate	Jan.	Per cent	3.9	3.8
	19:30	Japan	Workers' Household Spending	Jan.	Y/Y % chg.	0.3	2.2
	19:30	Japan	Tokyo CPI excl. perishables	Feb.	Y/Y % chg.	0.5	0.4
Feb. 29	---	Germany	Consumer Price Index	Feb.	Y/Y % chg.	3.0	3.0
	5:00	EU	Consumer Price Index	Feb.	Y/Y % chg.	3.2	3.1
	5:00	EU	Unemployment Rate	Jan.	Per cent	7.2	7.2
	8:30	Canada	Current Account (BOP)	Q4-07	$C, blns	-0.2	1.0
	8:30	Canada	Industrial Product Price Index	Jan.	% change	0.8	1.1
	8:30	Canada	Raw Materials Price Index	Jan.	% change	0.5	0.2
	8:30	U.S.	Personal Income	Jan.	% chg.	0.2	0.5
	8:30	U.S.	Personal Spending	Jan.	% chg.	0.2	0.2
	8:30	U.S.	PCE Deflator	Jan.	Y/Y % chg.	3.5	3.5
	8:30	U.S.	PCE Core	Jan.	Y/Y % chg.	2.2	2.2
	9:45	U.S.	Chicago Purchasing Managers Index	Feb.	Index	50.0	51.5
	10:15	*U.S.*	*Fed Governor Mishkin and Boston Fed President Rosengren speak at monetary policy conference in New York*				
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* Eastern Standard Time; Sources: Bloomberg, TD Economics